

EXHIBIT R

LOAN SERVICING/MONITORING

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Good loan servicing/monitoring is as important to a program's success as is the loan underwriting and credit decision making process. Servicing/monitoring includes payment collection, loan monitoring and compliance, evaluating the borrower on a periodic basis, and if problems occur, addressing the problems in a timely manner. Each loan requires a consistent review on a regular basis in order to ensure a successful program.

An RLF operator can contract for a portion of the loan servicing. However, the operator must still undertake certain loan servicing/monitoring activities. A loan servicing firm will typically provide some or all of the following services:

- Send out payment notices or provide a payment coupon book
- Collect payments
- Post payments
- Provide monthly or other periodic statements of loans paid, delinquent loans, loan balance, etc.
- Prepare and provide borrowers with information necessary for tax reporting (interest paid during year)
- Confirm payment of taxes and insurance
- Send notice of failure to pay

The loan servicing firm (financial institution, specialized loan servicing firms, etc.) can provide some or all of the above services. They do not, typically, provide services relating to the monitoring of the business, compliance with CDBG requirements, job monitoring and other related concerns. These activities include an annual site visit to the business, review of required financial statements, compliance with CDBG requirements, loan and grant closing, job monitoring, evaluating problem loans, loan work-outs, collateral preservation and foreclosure.

The following is a summary of the loan servicing/monitoring items:

Collection of payments: An established set of procedures needs to be established, applied consistently and on a timely basis. It is a good idea to use coupon books. The borrower will know the payment amount each month and get into a routine of payment.

If coupon books are not used, notices of payment due should be mailed to the business each month at the same time and provide the business with a week before the payment is due. The notices can include a statement of payments to date and the loan balance.

Past due notices: For loans that are past due, it is important to send a series of past due notices. After the first past due notice has been sent, a telephone call may be appropriate. After the second past notice is sent and not responded to in a timely manner, a site visit may be appropriate. Early intervention may identify a problem that can be resolved. Left too long, the problem may be insurmountable and foreclosure the only option.

Past due notices and borrower contact should be undertaken on a defined schedule. Each time a letter or notice is sent or the borrower contacted, it should be noted in the file. The file should indicate the nature of the contact and date for follow-up. It is critical to be consistent and timely.

Financial review: The Loan Agreement should require the periodic collection of financial statements from the borrower. The date financial statements are due should be noted in the tickler file. The income statement and balance sheet should be compared to previous statements and projections. Ratios should be calculated and compared to prior statements. Indications of problems include: losses not projected, lower margins, reduction in working capital, lower liquidity ratios, accounts payable or receivable problems additional borrowing and other credit analysis concerns.

Significant problems should be immediately investigated. Management and technical assistance may be required. Less serious problems should be monitored. The financial review is necessary to serve as a early indicator of problems.

Upon review of the financial statements, it is a good idea to conduct a site visit and meet with the borrower.

Other loan requirements: The Loan Agreement will contain other conditions, such as job creation and low and moderate income goals. In addition, the loan will contain both

financial and non-financial default provisions. The borrower should be monitored for compliance with these requirements. A non-financial default typically does not result in a foreclosure situation. However, notices should still be sent to the borrower to rectify the situation. Where the public benefit (i.e. jobs) or national objective of the CDBG loan is not achieved, State staff should be contacted for direction on how to proceed.

Problem loan remedies: Based upon the contact with the borrower, if collection is still a problem, a series of steps can be undertaken prior to deciding to restructuring the loan or foreclosing. These steps include referral to a Small Business Development Center for counseling, establishing frequent contact with borrower to address problems, engaging a consultant specializing in the area the business is having problems, hiring a financial consultant or CPA to review the situation and requiring increased financial reporting and monitoring. The key is staying on top of the situation, with frequent contact with the borrower. In some cases a letter from the lender's legal counsel is sufficient to trigger payment.

If the problem cannot not be addressed through management and technical assistance, it may be able to be solved through loan restructuring. Loan restructuring should only be undertaken after a complete analysis of the situation. Loan restructuring may be appropriate if cash flow is not sufficient to meet scheduled payments. It is not appropriate for other situations.

Under loan restructuring, it is essential that there is an agreement to the amount of payment to be made and when payments are due. The payment amount should be determined after a detailed review of financial information on the business, including detailed cash flow analysis. Restructuring can include the following:

- Forgiveness or carrying of past due interest
- Interest rate may be reduced for a specified period or for the remaining term of the loan
- The term of the loan can be extended
- A restructure of the amortization schedule to include a balloon payment
- Deferral of payments for a specified period

If a restructure is considered, as a lender, additional requirements (increased monitoring and reporting, restrictions on owner's draw, etc.) should be considered. Additional security may also be considered.

In negotiating a loan restructure, it is important to recognize that other lenders may be involved. The terms and conditions of their loan, as well as any intercreditor or subordination agreements, need to be reviewed to ensure that the restructuring can be undertaken.

Foreclosure: If restructuring and other assistance fails, it may be determined that the loan should be called and the collateral foreclosed upon. Prior to undertaking this action, it is critical that legal counsel be involved. The first step is to send notice to the borrower demanding payment of the loan in full.

If payment in full is not received, the next step will depend on the security for the loan. If there is no collateral for the loan, the borrower should be sued for repayment and a judgement should be obtained through court action. If personal property serves as collateral, a letter can be sent demanding that the personal property serving as collateral be turned over to the lender. An alternative is to work with the borrower to sell the personal property and turn the proceeds over to the lender. If these efforts fail, then litigation must be pursued to obtain a judgement.

If real estate serves as the collateral for the loan, foreclosure on the real estate should be undertaken under State law. There is an established process and time frame for foreclosing upon real property. If guarantees are involved, demands should be made upon the guarantors to recover losses. Again, litigation should be initiated if the guarantor does not respond to the demand with payment.

Bankruptcy: Before, during and after foreclosure, the borrower may file for bankruptcy. The bankruptcy court will establish the priority of creditor claims. A creditor committee may be established where a lender can be involved in the course and outcome of the bankruptcy process. There are three types of bankruptcy. Chapter 11 is a reorganization, with the intent to continue to operate. Chapter 7 is liquidation of assets. Chapter 13 is personal bankruptcy. The bankruptcy process is complicated and must be carefully monitored to ensure lender protection. Legal counsel should be involved in establishing a strategy, filing claims and the entire bankruptcy process.

LOAN COLLECTION SCHEDULE

- 1) **Send Payment Notices:** 7-10 days prior to payment due
- 2) **Payment due date:**
- 3) **Payment received:** Post payment
- 4) **Late payment:** 7-10 days after payment due
List delinquent borrowers
Impose late payment fee, if in
Loan Agreement
Send out late payment notice
- 5) **Borrower contact:** 10-15 days after payment due
contact borrower by telephone 30 days after payment due send
another notice of late payment due, schedule visit to
business
- 6) **Notice other lenders:** 30 days after payment due
provide notice to other lenders
- 7) **Develop strategy:** After payment is late by 30 days,
based upon established procedure, produce summary of actions
to be taken with borrower to correct the situation.
Evaluate work-out strategies. Discuss situation with legal
counsel. Based upon conversation with borrower, develop a
plan to provide management and technical assistance to
borrower. Review current financial statements.
- 8) **Late payment:** By 40 days after payment is missed,
confirm that the next monthly payment is either made or
missed. Maintain continuous contact with borrower. If second
payment made, continue to work on with borrower to ensure
payments are made on regular basis (identify problem). If
second payment not made, continue process of borrower
contact and business assistance.
- 9) **Implement strategy:** At the 60 day past due date,
determine whether to restructure the loan or to begin
foreclosure. Refer problem to legal counsel.

SAMPLE FORECLOSURE GUIDELINES

The collection function of servicing a loan is typically organized into several areas. This includes collection of past due payment, counseling of borrowers with financial difficulties and instituting foreclosure actions when necessary. The collection effort is vital to the viability of the RLF program, without collection of payments when due, the efforts of sound underwriting and originating the loan are fruitless.

Beyond solid underwriting and loan origination procedures, loan monitoring is critical. The _____ shall review the on-going financial statements submitted to detect problems early. When problems or negative trends are noted, the business shall be referred to _____ for business counseling. In addition, when the loan servicing agent notifies the _____ of a late payment, business counseling will also be undertaken.

Dealing with loan collection and perhaps foreclosure is complicated and requires compliance with strict legal standards. Foreclosure must be invoked as a last result. Under the RLF program, the loan collection agent ("Agent") will provide loan collection, servicing and asset liquidation. Asset liquidation will only be undertaken with concurrence with the _____ legal counseling.

The collection process will usually begin when a Borrower fails to remit payment. The first steps is that the Agent will send a reminder notice. The notice will ask the Borrower to check their records and to disregard the notice if payment has been sent. If payment is still not received by the specified date, the Agent will inform the _____. The Agent will also send out notice that the payment is delinquent and due immediately. The _____ Agent _____ and/or _____ will contact the business personally to determine the reason for the late payment. Business counseling will be scheduled. If the business is experiencing financial difficulties and unable to meet their obligations, a meeting between the business, Agent, _____, and _____ will be scheduled.

Communication between the business and the Agent/_____ is critical and a required part of the loan collection process. Judicious personal contact at this stage can prevent future problems, including legal actions. Based upon the personal contact, review of

the financial statements and business counseling, a decision will be reached by the _____, based upon the advice of the Agent and _____. The decision is whether additional counseling will improve the problem. If not, then there are essentially two options. The first is debt restructuring. This arrangement may call for reduced payments for a period of time. These discussions shall involve other lenders in the project. Such arrangements require careful analysis of the Borrower's situation and cooperation. Any arrangement constitutes a legal modification to the loan and must therefore be reduced to a written agreement. If the new agreement is breached, the _____ has preserved its legal right to foreclose. There may be other options, such as restructuring of the loan. However, any restructuring shall be made after consultation between the _____, Agent and _____, including legal counsel. The State of California, Housing and Community Development staff shall be advised.

If nothing can be resolved with the above steps, the Agent will send a demand letter to the Borrower. This letter will give the Borrower a short time period upon which to respond. If no response is received or the response is not satisfactory, then foreclosure procedures shall be undertaken by the Agent (with the _____ legal advisor providing concurrence). Foreclosure is the last step due to legal and other costs. The Agent shall undertake their normal foreclosure procedures and liquidate the assets to recover all or a portion of the RLF loan.